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Recent Developments: United States v. Carlton: Retroactive Application of an Amendment to 26 U.S.C. § 2057 (1982, Supp. IV 1986) Did Not Violate Due Process

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***United States v. Carlton*:**

RETROACTIVE APPLICATION OF AN AMENDMENT TO 26 U.S.C. § 2057 (1982, SUPP. IV 1986) DID NOT VIOLATE DUE PROCESS.

A retroactive application of an amendment that restricted use of 26 U.S.C. § 2057 (1982, Supp. IV 1986), which allowed for a deduction of half the proceeds of a sale of employer securities by the executor of an estate to an employee stock ownership plan ("ESOP"), was held to be non-violative of the Due Process Clause of the Fifth Amendment of the United States Constitution. The United States Supreme Court, in *United States v. Carlton*, 114 S. Ct. 2018 (1994), applied the rational basis test to the amendment and ruled that the retroactive application was rationally related to its legislative purpose.

Jerry W. Carlton ("Carlton") was the executor of the estate of Willametta K. Day ("Day"). On December 10, 1986, Carlton purchased 1.5 million shares of MCI Communications Corporation with estate funds at an average share price of $7.47 per share. On December 12, 1986, Carlton sold all of the MCI stock to the MCI ESOP at an average share price of $7.05 per share. On December 29, 1986, Carlton filed an estate tax return claiming a deduction under § 2057 of $5,287,000.00, half the proceeds of the sale to the MCI ESOP.

On January 5, 1987, the Internal Revenue Service ("IRS"), awaiting the enactment of actual legislation (the amendment to § 2057), stated that the § 2057 deduction could be used by estates of decedents only in cases where the stock in question was owned by the decedent immediately prior to death. The amendment to § 2057 was finally enacted on December 22, 1987. It was made effective as if contained in the statute originally enacted in October 1986.

The IRS disallowed Carlton's deduction under § 2057 because the MCI stock had not been owned by Day immediately prior to her death. Carlton was assessed a tax deficiency which he paid with interest. He filed a claim for a refund and initiated a refund action in the United States District Court for the Central District of California. He conceded that the estate did not qualify for a deduction under § 2057, but argued that retroactive application of the amendment to the estate's 1986 transactions violated the Due Process Clause of the Fifth Amendment. The district court rejected this argument and granted summary judgment in favor of the United States.

The Court of Appeals for the Ninth Circuit reversed, considering two factors to be of importance when determining whether retroactive application of a tax violates due process. The first factor was whether the taxpayer had actual or constructive notice that the statute would be retroactively amended. The second factor was whether the taxpayer reasonably relied to his detriment on the statute before its amendment. The court ruled that retroactive application of the amendment was un-

duly harsh and oppressive and thus violative of due process.

Justice Blackmun, delivering the opinion for the United States Supreme Court, began the analysis by stating that "[t]his Court repeatedly has upheld retroactive tax legislation against a due process challenge." *Id.* at 2021. The Court noted that the "harsh and oppressive" formulation does not differ in substance from the prohibition against arbitrary and irrational legislation with regard to economic policy. *Id.* at 2022. Hence, the due process test to be applied to tax statutes with retroactive effect is the rational basis test. Under this test, the legitimate legislative purpose of the statute must be furthered by rational means. *Id.*

The Court found that in enacting § 2057, Congress never intended the statute to have such a broad application. The intent was to create an incentive for shareholders to sell to the employees, those who helped build the company. *Id.*

The Supreme Court concluded that the 1987 amendment did not violate due process. First, the Court stated that Congress acted "to correct what it reasonably viewed as a mistake in the original 1986 provision that would have created a significant and unanticipated revenue loss." *Id.* at 2023. Second, Congress had acted promptly and the period of retroactivity was only modest. *Id.*

The Court rejected Carlton's argument that he relied on the original provision by noting that "[t]ax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code." *Id.* In addition, the Court rejected Carlton's lack of notice argument by quoting *Milliken v. United States*, 283 U.S. 15, 23 (1931): "a taxpayer 'should be regarded as taking his chances of any increase in the tax burden which might result from carrying out the established policy of taxation.'" *Id.*

Justice Scalia, in a concurring opinion in which Justice Thomas joined, obviously irritated by the majority's opinion, began his analysis by stating: "If I thought that 'substantive due process' were a constitutional right rather than an oxymoron, I would think it violated by bait-and-switch taxation." *Id.* at 2026. Scalia critiqued the Court's characterization of the amendment as "a curative measure" and stated that "what was done to respondent here went beyond a 'cure.'" *Id.* He noted that the retroactive disallowance of the tax benefit that the earlier law allowed, without compensating those who incurred expenses by accepting the offer, is "harsh and oppressive by any normal measure." *Id.*

Scalia did, however, express agreement with the Court that the Due Process Clause does allow for retroactive taxation, since he believes that the Clause "guarantees no substantive rights, but only (as it says) process . . . ." *Id.* at 2027.

In summary, the Supreme Court held in *United States v. Carlton* that a retroactive amendment restricting use of a deduction under 26 U.S.C. § 2057 (1982, Supp. IV 1986) was not violative of the Due Process Clause of the Fifth Amendment. While such an amendment may not violate due process, it certainly violates this author's perception of what a free market economy should be. It is beyond comprehension that some legislators fail to see that what is best for the economy is to keep this country's assets in the hands of private individuals. It is only private individuals that have an incentive to efficiently and productively use these assets. It is only private individuals that have a "bottom line" to worry about. The federal government has no such bottom line to worry about, despite its claims to the contrary.

The reason for the amendment to § 2057 was because of an unanticipated revenue loss by the government of $7 billion over a five-year period. The loss of $7 billion in revenue over a five-year period is a minuscule amount given the size of the United State's economy as measured by gross domestic product, or any standard of measurement for that matter. However, I am sure that the revenue provided by the amendment will be put to good use by the federal government. I understand that the money is ear-marked for the coffers of such successful programs as

welfare, the illicit drug importation war, and the space program. Good luck middle-class America.

- *Paul J. Mantell*

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